BUSINESS IN BRIEF

Business activity is now moving ahead. And most signs point to a normal recovery during the remainder of the year.

This does not necessarily mean that a rapid advance lies ahead. Experience in past business cycles shows that it usually takes 6-9 months for industrial production to regain its previous peak. Moreover, moderate recessions are generally followed by recoveries which are relatively less vigorous than those after more severe recessions.

However, if the recovery is reasonably comparable to those in the past, industrial production could rise 15% or more in the year ahead. To assess the possibilities of achieving such a recovery, consider trends in major areas of the economy.

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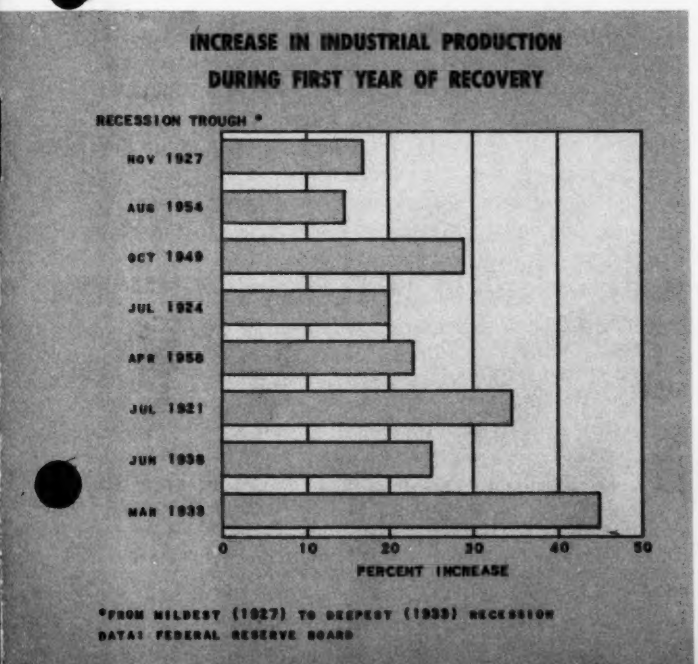
The inventory adjustment is drawing to a close. This can be seen most clearly in steel and autos. Steel production is up 50% from its low in December, as the cutback in stocks in the hands of steel users is at long last about complete.

April sales of domestic cars rose 28% from the low in February. Assemblies were held at a low level in the first quarter, so inventories at the end of April had been worked down to 912,000 units. Thus, production could rise in line with sales in the months ahead.



An about-turn in inventory-buying policies can provide a significant upward push to business activity. The $16 billion shift from adding to inventories in early 1960 to cutting them in early 1961 was the major factor in the recession. By the same token, a swing to moderate accumulation of stocks later this year could boost orders and industrial production.

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At the same time, other areas of the economy show upward trends:

¶ **Personal income** turned up in March after a very mild decline (less than 1%) from October 1960 to February 1961. This stability in income helped hold up retail sales during the recession. And seasonally adjusted sales in March and April averaged almost 2% above the January low.

¶ Recent surveys show that **business investment** in new plant and equipment should increase during the second half of the year. If Congress approves the proposed tax changes to encourage investment, a further rise in capital investment could be generated.

¶ **Housing starts** moved up 4% in the first quarter, reversing the twenty-month decline which began in May 1959.

¶ Total **government cash expenditures** have increased at a rate of $11.4 billion in the past year, with over half the increase coming at the Federal level. The Administration's program calls for a rise in Federal spending on the order of $5 billion in the year ahead. Thus, total government expenditures could rise almost as much as in the past year.

¶ **Exports** moved higher in the first quarter while **imports** declined a bit. These trends could reverse before year's end, but perhaps in no more than a moderate fashion.

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When you add up these trends, you see how a normal recovery could develop in the year ahead. Yet the problem is to make sure that the advance carries beyond the next year, and on to full prosperity. To achieve this goal will require hard and effective work on the part of business as well as national economic policies which will support vigorous economic growth without inflation.

MONETARY POLICY AND BUSINESS RECOVERY

Spreading evidence that business recovery may be underway has not yet prompted any basic shift in monetary policy. Thus, short-term funds have remained freely available in the money market, with three-month Treasury bills staying within the general 2⅛ – 2½% range established as long ago as last summer. Member banks are still virtually free of debt to the Federal Reserve, and the nation's money supply has continued to rise. In fact, while still slightly below its 1959 peak, growth in the money supply has picked up, increasing at an annual rate of almost 3½% over the first four months of the year.

The Long-Term Capital Markets

During the past few months, the bulk of the reserves required to support this increase in the money supply has been provided by Federal Reserve purchases of intermediate and longer-term Government securities – aggregating over $1 billion from late February through early May. Helped by this direct support, yields of those issues recently touched new lows for the year. In the mortgage market, too, rates still appear to be drifting lower, although less rapidly than earlier in the year.

Meanwhile, yields of newly-offered corporate bonds, reacting to a sharp increase in the supply of new issues, have advanced roughly ¼% above their lows. But, the large volume of new financing – apparently induced partly by rate declines in January and February – has been absorbed without real strain.

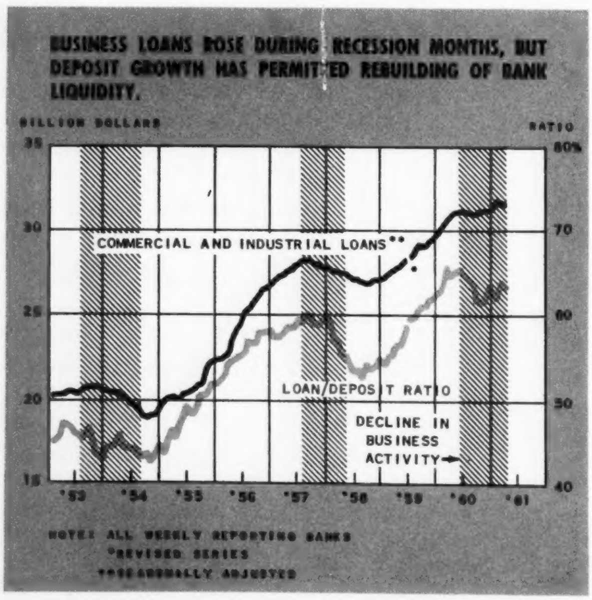
Prospects

Under these circumstances, there is no evidence that a shortage of lendable funds is currently hampering business expansion. As rising private investment generates larger credit demands, however, further sizable injections of bank reserves may be necessary to facilitate full recovery.

- Loan volume of commerical banks has remained high during the recession period, actually increasing by about 4% over the past year. While deposit growth has enabled banks to partially restore their liquid asset position, loan/deposit ratios have not dropped so rapidly as in earlier recessions. One implication is that growth in the money supply and bank deposits, at a faster rate than during earlier postwar years, may be required to support an increase in loans in line with vigorous business expansion.
- Indications are that corporate liquidity positions have been slow to improve during the past recession. For example, the ratio of cash and Government securities to current liabilities at the end of 1960 was .37, the lowest for any year-end date since World War II. Thus, business may be more sensitive to changes in the availability of external funds than was the case earlier in the postwar period.
- Perhaps most important, the Federal Government, despite a rising trend of expenditures, is currently running a relatively small deficit compared to the 1958 recession. Recent estimates indicate a further cash deficit of about $4 billion will be incurred for the full fiscal year beginning in July. But the sort of business recovery that might potentially pose strong inflationary dangers would, at current tax rates, generate a large increase in revenues. Then, the budget would swing into surplus, tending to restrain the advance and reducing the need for sharply restrictive monetary policy.

This does not mean that, in the face of a business upturn, a valid case can be made for pressing aggressively for still easier money today. For one thing, both Federal Reserve and Treasury officials have pointed out that the sensitivity of short-term capital flows across international borders to interest rate differentials remains a constraint on policy. While the outflow from this country has subsided in recent weeks, short-term rates in some key foreign markets are still above those in this country. A widening of those differentials could bring new pressures on the dollar. Moreover, the increase in liquidity that might be required to force rates still lower today could tomorrow pose the risk of a resurgence of inflationary pressure.

But the fact that the economy is less liquid now than during earlier periods of recession does suggest that the Federal Reserve may continue its current policies for some time – delaying any move toward restraint until the economy is operating much closer to its full potential. Such an approach would appear consistent with its responsibilities to encourage growth without inflation.

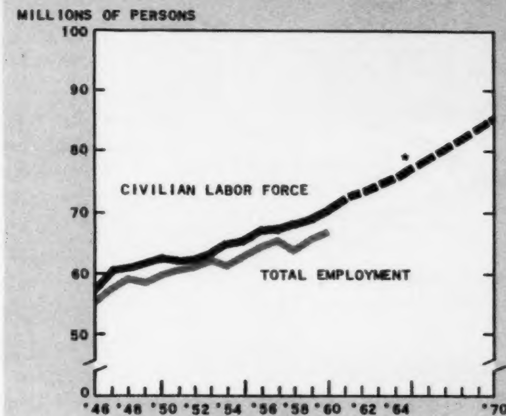


THE UNEMPLOYMENT PROBLEM

The problem of unemployment has been much in the news of late. The fact that 5 million persons have been listed as unemployed has evoked considerable comment at home and abroad. And it has been suggested in some quarters that this nation might face a continued and intractable problem of unemployment in the years immediately ahead.

There is little question but that the current rate of unemployment is too high. A free society must offer opportunities to individuals who are willing and able to work. Excess unemployment involves very real human costs to the individuals directly affected as well as a cost to the economy in terms of foregone production.

LABOR FORCE GROWTH WILL ACCELERATE IN THE COMING DECADE



*PROJECTIONS ASSUME CONSTANT-SIZED ARMED FORCES

DATA: DEPARTMENT OF LABOR

The Recent Record

Yet it is important to view the problem in perspective. To do so involves looking at where we stand now in relation to past trends, what our unemployment figures really measure, and what the nation can and should do to provide adequate job opportunities.

Almost 5 million people were seeking work in April. That was 6.8% of a civilian labor force estimated at 70.7 million. The seasonally adjusted unemployment rate has held virtually stable since December.

- That's a better performance than in two of the three previous recessions. At the trough of the 1949 recession the unemployment rate was 7.8%, and it was 7.5% in August 1958. In September 1954 it was 6.2%, almost as high as the recent average.
- As many people are at work now as were at the onset of the recession a year ago — in contrast, earlier postwar recessions saw declines in employment of 2-3%.

An average sort of recovery from the current recession low could provide a substantial increase in job opportunities in the next year. Past experience would suggest that employment could rise by 2-3½ million.

Such a recovery, if it could be achieved, would cut unemployment substantially. Yet certain problems would remain. To see their general dimensions, consider the manner in which the unemployed are counted.

In contrast to the procedure in most other nations where only those who lose a job are counted as unemployed, the U. S. figure encompasses anyone who is looking for work. Thus, in addition to those laid off, we include new job seekers, those who are waiting to be called back to a job, those who are waiting to report for a job within 30 days, those who would have been looking for work if they believed jobs might be available.

Because of this broad definition, the minimum unemployment rate in periods of good business may well be a bit above 4%. This means that reported unemployment could run to more than 3 million in 1962 even with a good rate of economic recovery.

Most of this level of unemployment would represent what has been termed "frictional unemployment"—people moving from job to job or those in the process of entering or leaving the labor force. Estimates for the period 1955-57, when unemployment averaged 4.3% of the labor force, placed such frictional unemployment at 70% of the total.

The remainder — some 900,000 unemployed — is the hard core of the problem in the sense that this number of individuals cannot find jobs even in times of general prosperity. Such unemployment has been termed "structural". Some of it is a result of technological change which requires new skills on the part of workers who are displaced. Another part results from the problem of depressed areas.

Rapid Labor Force Growth

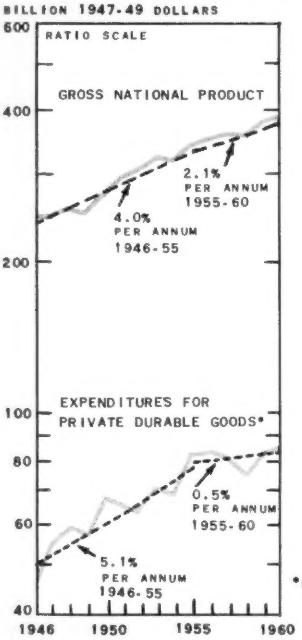
The rapid growth in the labor force poses another problem. In the past year, the number of persons seeking work has increased by more than 2 million, largely because more women and younger people have entered the labor force. That's an unusually large increase especially for a recession period when labor force growth generally eases off.

The average annual growth in the labor force in the 1960's is expected to run to 1.4 million, 66% greater than the average during the 1950's. Obviously, job opportunities must be provided at a faster rate if the nation is to deal with the unemployment problem. This will require vigorous growth in the general economy.

Beyond that lies the need to train or retrain individuals for the sorts of jobs which would be available in an expanding economy. Currently, unemployment is heaviest among laborers and less-skilled workers who are less in demand than those with higher skills and better education. In the long run, therefore, education plays a key role in reducing structural unemployment.

THE ROLE OF DURABLES

I. THE NATION'S ECONOMIC GROWTH SLOWED AFTER 1955 — IMPORTANTLY BECAUSE OF A SLOWDOWN IN SALES OF DURABLE GOODS



*BUSINESS PLANT AND EQUIPMENT, HOUSING AND CONSUMER DURABLES

Private durables – business plant and equipment, consumer durables and housing – hold an important place in our economy. In the postwar period, they have averaged, with little annual variation, more than 22% of gross national product. A strong market for durables, thus, seems essential for prosperity and economic growth.

In fact, the slowdown in economic growth that has been apparent since the end of 1955 seems to be related to trends in sales of durable goods. By the end of 1955, backlogs of demand for durables had been made up; also, new households were being formed at a lower rate. Although replacement demand increased, expenditures for durables rose only .5% per annum from 1955 to 1960 against 5% per annum from 1946 to 1955. At the same time, the rate of growth of GNP dropped from 4% to 2% per annum.

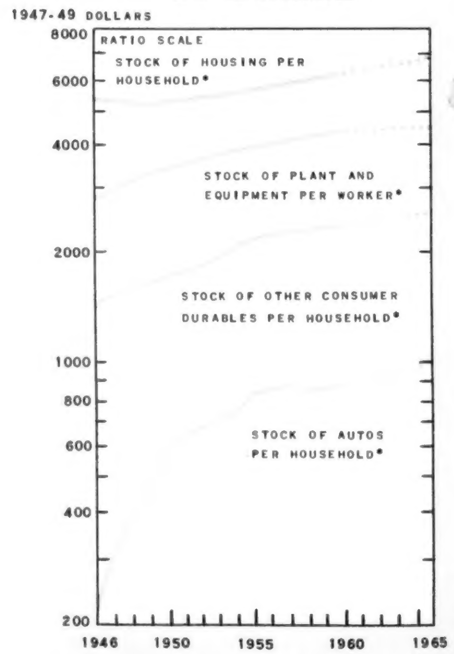
In the next few years, the factors underlying the durable markets should swing to the favorable side, and the markets for durable goods have a *potential* for expansion that could significantly accelerate our overall economic growth. The accompanying charts represent a potential, not a forecast. The challenge is to develop this potential by vigorous action on the part of business together with national economic policies that support growth without inflation.

II. IN THE NEXT FEW YEARS FACTORS UNDERLYING DURABLE GOODS MARKETS COULD SWING TO THE FAVORABLE SIDE

In the early postwar period, households and businesses tried to increase their stocks of durables which had been held down in the Depression and War years. With the backlogs largely made up by the end of 1955, the next few years represented a process of adjustment to a more normal rate of growth. There is, however, room for further growth in stocks of durables per household and per worker. The projections shown are well in line with past trends. In addition, household formation, which placed a check on durable sales in the late Fifties, should rise.

HOUSEHOLD FORMATION SHOULD RISE

THERE IS ROOM FOR FURTHER GROWTH IN THE STOCKS OF DURABLES PER WORKER AND PER HOUSEHOLD



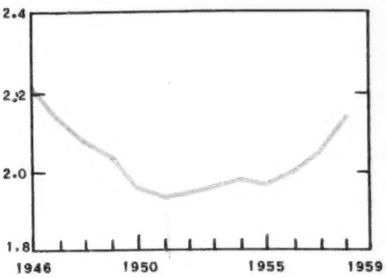
*DEPRECIATED VALUE OF STOCKS IN EXISTENCE IN EACH YEAR PER HOUSEHOLD OR PER WORKER

DATA: RAYMOND GOLDSMITH, NATIONAL BUREAU OF ECONOMIC RESEARCH, UNPUBLISHED DATA; DEPARTMENT OF COMMERCE AND MACHINERY & ALLIED PRODUCTS INS

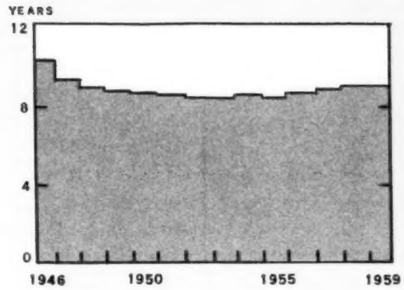
ES IN ECONOMIC GROWTH

III. OUR STOCK OF CONSUMER DURABLES AND BUSINESS EQUIPMENT HAS BEEN AGING . . .

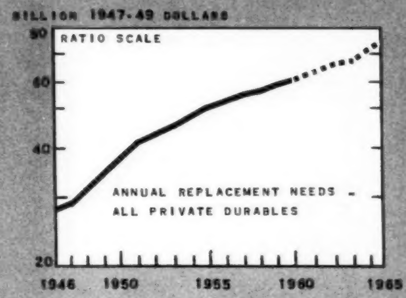
AGE OF CONSUMER DURABLES
Measured by Ratio of Gross to Net Stocks



AVERAGE AGE OF BUSINESS EQUIPMENT

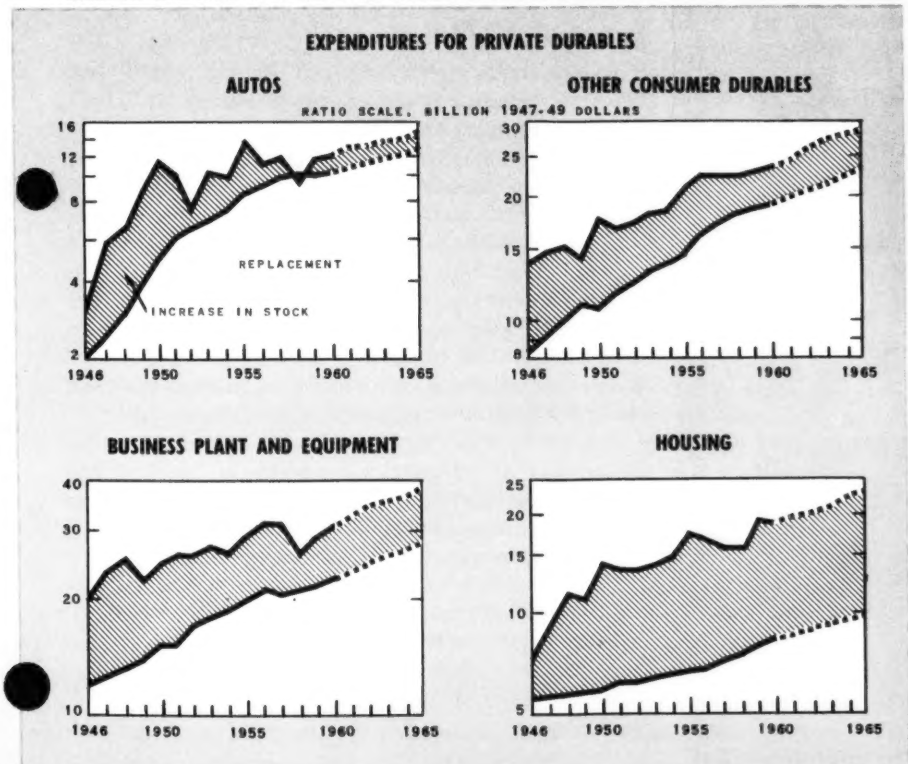


SO EXISTING DURABLES NEED TO BE MODERNIZED AND REPLACEMENT DEMAND SHOULD CONTINUE TO RISE

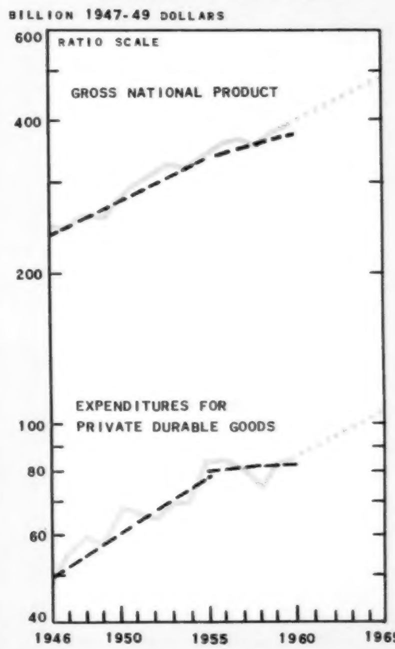


IV. THESE TRENDS ADD UP TO A POTENTIAL GROWTH IN DURABLES MARKETS WHICH COMPARES FAVORABLY WITH EARLIER YEARS.

The expansion in markets for durables is possible, in large part, because of the growing importance of replacement demand. This is particularly prominent in the case of autos and other consumer durables.



V. IF THESE POTENTIAL MARKETS COULD BE DEVELOPED, THIS WOULD PROVIDE A STRONG UPWARD PUSH TO THE GENERAL ECONOMY



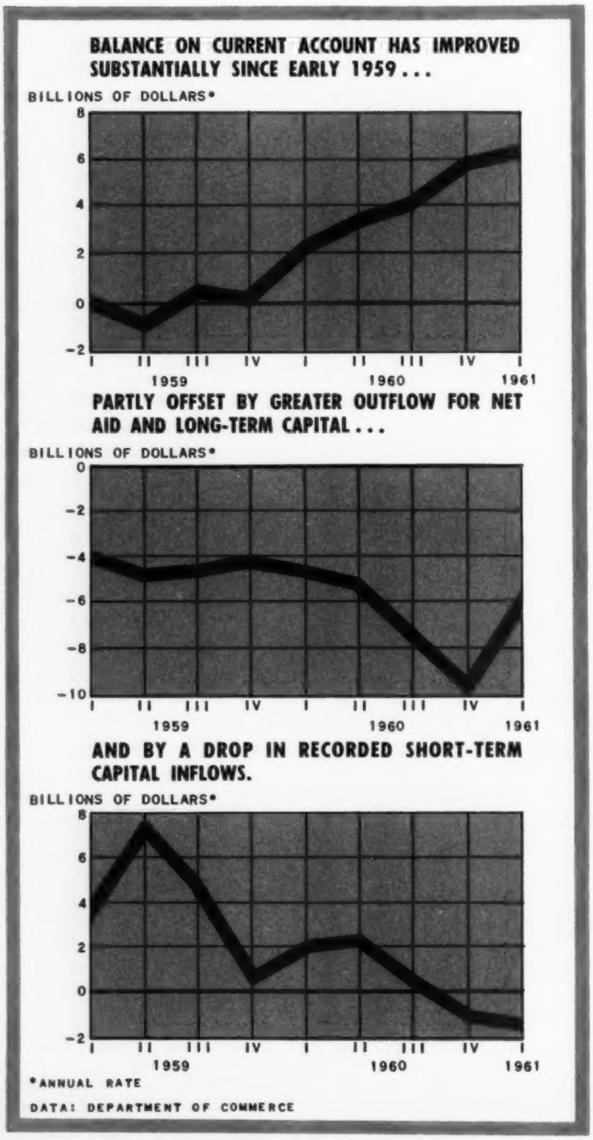
CTS INSTITUTES. PROJECTIONS PREPARED BY THE CHASE MANHATTAN BANK.

SHORT-TERM CAPITAL AND THE FOREIGN BALANCE

The U. S. foreign trade balance has shown growing strength over the past two years. Exports have been rising since early 1959, while imports have actually fallen off a bit. Estimates of the U. S. trade balance in the first quarter of this year indicate a surplus of about $6.4 billion at annual rates – compared to a surplus in 1959 of only $900 million.

However, despite this basic improvement, the overall deficit in the U. S. balance of payments in 1960 was $3.8 billion – just as large as in 1959. The main reason for this was a big pick-up in the outflow of short-term capital from the U. S. Adverse short-term capital movements continued into the first quarter of 1961.

The large deficit in 1960, in the face of continued improvement in the trade balance, raises several important questions: What is the nature of the short-term capital flows? Why have they recently become larger? And what are the implications for U. S. policy?



Short-Term Capital

It is customary to divide short-term capital movements into two basic components:

First is the purchase or sale of foreign liquid assets by U. S. banks, mainly on customer account, corporations or individuals. Until recently, capital flows of this nature varied according to the trade and investment needs of U. S. corporations in overseas operations. While they were influenced by interest rate differentials between the U. S. and the foreign country where the funds were needed, large speculative investments were not feasible so long as the currencies involved were not freely convertible. The average net short-term outflow of U. S. money for the ten years 1950-59 was $224 million. However, in 1960 the net outflow reached $1.2 billion.

Second is the purchase and sale of U. S. liquid assets (such as bank deposits, Government securities, bank acceptances) by foreign entities. To the U.S. these constitute liquid foreign liabilities. Their importance stems from the dollar having become widely used in international transactions. During the eleven years between 1950 and 1960, official Free World dollar holdings rose $6.3 billion – almost one-third of the total net increase in official gold and foreign exchange holdings of the Free World outside the U. S.

Enter Convertibility

So long as the dollar remained the only widely used reserve currency, with other major currencies subject to controls limiting their convertibility, short-term capital movements tended to be relatively moderate. In these years a rather persistent U. S. deficit was financed largely by means of increases in liquid dollar liabilities. Private banks accumulating dollars would sell them to their central banks which would generally keep most of the funds in interest-earning dollar assets rather than gold. There was little incentive to transfer funds to other money markets in response to higher interest rates because, once converted into another currency, these funds could not readily be reconverted to dollars or gold.

But starting in 1958, a number of European countries began to relax foreign exchange controls. By 1960, the British pound, the French and Belgian francs, the Italian lire, the Dutch guilder, the German mark, as well as the Swiss franc, were fully, or practically, convertible. As a result, the flow of short-term funds between major world money markets could expand substantially. This had two important effects. On the one hand, it further increased the potential store of international liquidity: with a growing number of stable reserve currencies, a much larger volume of trade and investments could be handled than before.

On the other hand, without a way to offset large flows of short-term capital, they may become excessive. Countries with only moderate foreign reserves might then be forced to re-adopt exchange controls.

The Big Outflow

Thus general currency convertibility, though one of the foreign policy goals of the United States, poses a difficult problem — one which became acute in the U. S. in 1960. Between 1959 and 1960 the recorded short-term capital inflow into the U. S. fell from over $3.2 billion to about $900 million. At the same time, unrecorded flows — suspected of being largely short-term capital movements — went from an inflow of $783 million to an outflow of $905 million.

These reversals were not entirely due to greater convertibility of world currencies. In part they arise because of the improvement in the trade balance — there is a smaller net deficit on all trade and long-term capital accounts that needs to be financed with short-term capital movements and gold sales.

More important, the incentives to hold short-term funds in the U. S. became unfavorable. The recession in this country helped keep down interest rates while the economic boom in Europe pushed up interest rates there. Because of this, starting last spring, the fully hedged interest rate differential between the U. S. and the major European money markets became substantial, and has only markedly declined since February of this year.

The outflow of funds in the summer of 1960 required foreign central banks to absorb a growing volume of dollar balances. However, in the last half of 1960 they bought gold from the U. S. Treasury equivalent to about two-thirds the increase in the dollar assets they acquired.

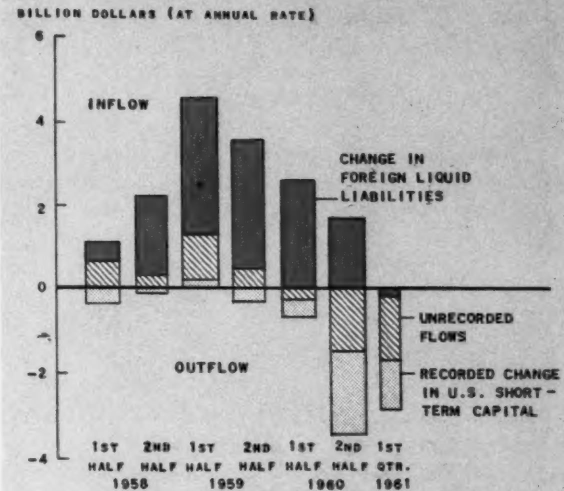
The large Treasury sales of gold during this period, plus the concern that had been generally expressed over the U. S. balance of payments since 1957, created a speculative atmosphere in the gold markets — especially in London — that temporarily pushed the gold price above $40 an ounce. It is clear that the U. S. dollar was not in immediate danger last fall — the balance of trade and long-term capital account were in relatively good shape, and U. S. gold reserves were more than ample to meet a temporary crisis. But the speculative wave accelerated the already substantial outflow of short-term capital. And as central banks bought gold, their rate of accumulation of dollars also fell off further. That the short-term capital outflow continued into the first quarter of this year despite a further increase in our export surplus may well be due to this speculative scare.

By March the gold outflow had stopped, and indirect evidence suggests that the short-term capital flows have been much more moderate since then.

The Lessons

Three conclusions emerge with some clarity from the experience of the past year:

NET SHORT-TERM CAPITAL INFLOW HAS DROPPED CONTINUOUSLY SINCE FIRST HALF 1959



*EXCLUDES $1,375 MILLION ADDITIONAL SUBSCRIPTION TO THE INTERNATIONAL MONETARY FUND.
DATA: DEPARTMENT OF COMMERCE

First: We must face the implications of widespread convertibility: the large trading nations — even those that now appear secure behind massive reserves of gold and foreign exchange — may be subject to an intolerably rapid short-term capital outflow in response to interest rate differentials or the expectation of a change in the parity of a currency. Such capital movements perform useful economic functions and should not be stopped. However, we have seen that they can upset the very structure of international payments. Thus some institutional change is called for; various proposals are being studied to modify the operations of the International Monetary Fund to deal with this problem.

Second: One reason the situation last fall did not become grave was the strong expansion of our trade surplus. So we should make every effort, on a national as well as an individual business level, to stimulate exports.

Third: The U. S. should not permit the dollar price of gold to become subject to wild speculation in any of the major gold markets. The experience of last fall and winter suggests very clearly that the cost of remaining aloof is high in terms of public confidence.

The short-term capital flows are, of course, part of our overall balance of payments problem. And one of the reasons they have become more pronounced is that the economies of the Free World have become stronger and more fluid. There is clearly a need to improve our international machinery so that temporary periods of instability do not become serious economic crises. But there is no doubt that this can be done. The U. S. effort should be toward finding an institutional arrangement that solves this problem without halting the trend toward greater economic interdependence among free nations.

Choosing a Silk Shantung—Photo by Ted Croner